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## Continuing Conundrum of Mistakes: Where the Dodd-Frank Act Went Wrong

*Shipra Mehta\**

### INTRODUCTION

After the most recent financial crisis that befell the United States, financial federal regulations governing the country's financial institutions required drastic restructuring. After a great deal of debate and consideration of the various alternatives, the Dodd-Frank Wall Street Reform and Consumer Protection Act (hereinafter "Dodd-Frank" or the "Act"), was enacted into federal law by President Obama in July 2010.

Before the Act, in 2008, financial federal regulation needed changes for three primary reasons. First, the ongoing emergency that the country was being assaulted with began in housing and credit markets, but the effects spread and it was eventually followed by the collapse of many financial institutions and a subsequent recession.<sup>1</sup> Second, breakdowns in the enforcement and fraud deterrence goals of federal financial regulation led to the possibility of some financial fraud schemes that left some investors reeling.<sup>2</sup> Finally, the misalignment between the federal regulation firms and the intermediaries led to inefficient and ineffective enforcement of the regulations that were already in place.<sup>3</sup> Due to these primary concerns underlying the desperate need for federal restructuring, the ideas underlying the Dodd-Frank took root.

The Dodd-Frank Act is characterized as a major overhaul of the United States system of financial sector regulation.<sup>4</sup> The purpose of enacting the Act was to address some of the glaring issues raised by the recent financial crisis by filling some of the significant gaps identified in the pre-crisis regulatory framework.<sup>5</sup> However, despite the

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1. Joel Seligman, *Tyrell Williams Lecture: Key Implications of the Dodd-Frank Act for Independent Regulatory Agencies*, 89 WASH. U. L. REV. 1 (2011).

2. *Id.* at 2.

3. *Id.* at 3.

4. Saule T. Omarova, Article: *The Dodd-Frank Act: A New Deal for a New Age?*, 15 N.C. Banking Inst. 83, 84 (2001).

5. *Id.*

eventual identified goal of the Act, it falls short as it provides too many loopholes and little substantive guidance to ensure that it actually accomplishes what it is purported to do, leading to the several criticisms.<sup>6</sup> Rather than providing a workable system that provides the regulators with authority and tools to deal with systemic risk, the Act requires over two hundred and twenty-five new financial rules across eleven agencies, which again does not provide very little substantive guidance.<sup>7</sup>

Moreover, despite the multitude of new rules, the legislation contains several gaps and omissions that the run the risk of the Act being inadequate to sufficiently protect the American public. Through its primary focus on minimizing systemic risk, the Act leaves several other areas unprotected, and thus inadvertently increases the chances of systemic risk. Therefore, the Act must be supplemented with further measures such as a global regulator that could fill the holes in the areas the Act leaves unprotected while simultaneously providing disincentives to firms from never-ending growth and thus widen its protective and regulatory breadth.

Part II of this Article examines the general provisions of the Dodd-Frank Act, including providing further detail regarding Title IV, the section applicable to hedge funds. Section III examines several of the criticisms commentators have stated about the Dodd-Frank Act regarding its primary focus on systemic risk at the expense of other areas such as deficiencies in the existing and newly implemented organization structure, inconsistencies in regulation, minimal emphasis on investor protection, and lack of an international focus. Section III then proposes a solution that could minimize if not eradicate several of the criticisms through the implementation of an international regulator.

## BACKGROUND

### *The Dodd-Frank Act Generally*

The Act's goal is to reduce systemic risk within the American financial system through the implementation of several procedures and institutions. The primary way the Act accomplishes this is by subjecting all important financial activities within the United States to an ulti-

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6. *Id.*

7. Viral Acharya, Thomas F. Cooley, Matthew Richardson, Richard Sylla, Ingo Walter, *A Critical Assessment of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, (November 24, 2010) <http://www.voxeu.org/article/dodd-frank-critical-assessment> (last visited March 20, 2016).

mate financial regulator overseeing systemic risk. This is accomplished via several steps such as providing more effective coordination, establishing new powers for the Financial Stability Oversight Council, reducing gaps and omissions within the regulations, and enacting substantive limits that should reduce financial risk.<sup>8</sup> Now, the Financial Stability Oversight Council (hereinafter “Council”) has the authority to require new capital, liquidity and risk management standards for banks and non-bank financial companies.<sup>9</sup> The initial increase of powers afforded to certain organizations is supplemented by new enhanced monitoring, supervision and enforcement methods that are designed to minimize, if not prevent, potential system-wide economic harms while expanding regulatory authority over large, inter-connected non-bank financial institutions.<sup>10</sup>

In terms of the perceived gaps and omissions that were present within the financial regulation prior to the Act, the Act attempts harmonization by making regulatory departments and agencies less independent of each other along with the executive and legislative branches.<sup>11</sup> With an increased focus on regulatory coordination amongst the pertinent agencies and departments, the Act attempts to optimize early warning and quick responses to growing crises *before* they happen rather than as a reactive measure.<sup>12</sup> All these measures are primarily designed to minimize systemic risk within the industry. Systemic risk has been such a major concern of the financial industry that many of the regulations imposed since the recent financial crisis are geared towards minimizing it.<sup>13</sup> In fact, even before the Dodd-Frank Act was passed, the regulatory organizations that were involved with mitigating the harmful effects of the recession seemed to focus on minimizing systemic risk from the very beginning.

One of the Act’s most controversial changes is the enactment of Title IV, which deals primarily with investment companies such as hedge funds, which will be discussed in further detail below.

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8. *Id.* at 11-12.

9. *Id.* at 5.

10. Cheryl D. Block, *A Continuum Approach to Systemic Risk and Too-Big-to-Fail*, 6 BROOK J. CORP. FIN. & COM. L. 289, 293 (2012).

11. Seligman, *supra* note 1, at 6.

12. *Id.*

13. Cary Martin, *Is Systemic Risk Prevention the New Paradigm? A Proposal to Expand Investor Protection Principles to the Hedge Fund Industry*, 86 ST. JOHN’S L. REV. 87, 101 (2012). For example, in response to the financial crisis, Congress created the Congressional Oversight Panel, which then released a report in January 2009 that analyzed the then current state of the regulatory system and made specific recommendations for regulatory reform. Many of those recommendations focused on identifying and regulating financial institutions that posed a systemic risk to the economy. *Id.* at 101-102.

*Title IV of the Dodd-Frank Act*

As the title applicable to hedge funds, one of the more impactful changes contained within Title IV of the Dodd-Frank Act (hereinafter “Title IV”) is changes to investment adviser registration under the Investment Advisers Act of 1940 (hereinafter “Investment Advisers Act”) that applies to almost all investment advisers.<sup>14</sup> Title IV sets standards for when investment advisers must register under the Investment Advisers Act; it does not always necessarily require adviser registration as there are times when registration is required, it is optional and even when it is prohibited.<sup>15</sup> Title IV also clarifies the authority to define “client” under certain situations, imposes new and improved recording and reporting requirements, modifies the custody obligations on registered investment advisers and adjusts the “qualified client” and “accredited investor” suitability standards under the Advisers Act and the Securities Act of 1933.<sup>16</sup> Finally, Title IV seems to provide clearer Congressional guidance on what constitutes systemic risk and scales the registration and reporting requirements accordingly.<sup>17</sup>

The general policy underlying all these changes imposed by Title IV is based on the premise that larger hedge funds and private equity investment advisers should be governed by federal regulation while smaller investment advisers and venture capital advisers can be left to state regulation.<sup>18</sup> However, this still leaves the door open for increased federal regulation for mid-sized investment advisers.<sup>19</sup> This is just an example of the Act’s nearsightedness on how in its narrow focus on systemic risk, it could actually increase the potential for systemic risk.

## ANALYSIS

Despite all the effort and research before the Act was implemented, there are still numerous criticisms regarding the Act, one of the primary ones being related to systemic risk.<sup>20</sup> Based on the numerous gaps, omissions and deficiencies discussed below, it is evident that by focusing almost primarily on minimizing systemic risk, the Act leaves

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14. Seth Chertok, *A Detailed Analysis of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 6 VA. L. & BUS. REV. 1, 4 (2011).

15. *Id.*

16. *Id.*

17. *Id.* at 24.

18. *Id.*

19. *Id.*

20. See Securities and Exchange Commission MCMXXXIV, Staff Report (2003).

open several possibilities through which systemic risk could actually increase, endangering the economy as a whole. Essentially, due to its narrow focus, the Act may fail to do exactly what it was designed to prevent.

### *Criticisms of the Dodd-Frank Act*

Despite the fact that the Act was considered to solve a majority if not all the problems that befell the American financial system and that led to the subsequent recession, criticisms of the Act abound. One of the most prominent criticisms is that by focusing almost exclusively on the reduction of systemic risk, the Act has not made changes that could actually impact the financial industry if a crisis like this re-occurred, and has left some substantial gaps within the regulatory devices. Some commentators have even theorized that let alone the Act not implementing changes that could actually impact the financial industry, the Act has an innate principal inability to minimize systemic risk.<sup>21</sup> Several factors contribute to the inability.

First, the approach that Dodd-Frank follows just builds on the old financial regulatory agencies' structure; it does not actually make the structural changes needed to prevent another widespread economic crash from occurring.<sup>22</sup> By strengthening the power and authority of most of the older agencies such as the SEC and the Federal Reserve System, these agencies "won" even though they were the ones that completely failed in reacting in an adequate and appropriate manner, which did not help in resolving the crisis.<sup>23</sup> Just because they were the ones with the power, they still left the fracas unscathed and holding the baton despite their recent mistakes. The same basic structure that most likely contributed to the latest crisis still remains with a few superficial changes.

Along the same lines, prior to the Act, banks seemed to contain a large amount of systemic risk within the industry; today, while they may not pose as much of a risk directly, non-banks perform bank-like functions that still contain the earlier risks along with the new risks introduced into the financial markets that are not directly addressed by the Act.<sup>24</sup> Changes have not been made to actually counteract risks present within a "bank-esque" organization. By not recognizing

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21. Charles Whitehead, *Local to Global: Rethinking spheres of Authority After a World Financial Crisis: Regulating for the Next Financial Crisis*, 24 PAC. MCGEORGE GLOBAL BUS. & DEV. L.J. 3, 5 (2011).

22. Seligman, *supra* note 1, at 6.

23. *Id.*

24. Whitehead, *supra* note 21, at 5.

the “fluidity” of the risk being transferred from banks to less-regulated firms, many risk factors are left unregulated that might still majorly impact the financial industries.<sup>25</sup>

Second, the Act affords a great deal of power to the Council as a way of minimizing systemic risk through more coordinative regulations and substantive limits, but the question arises whether the Council has any actual power. Various components of the Council’s organizational structure prevent it from functioning as an effective tool to actually reduce systemic risk. For example, the Council only meets occasionally, it does not have the staffing resources that the other agencies have making it dependent on other agencies for enforcement, and it is chaired by the Secretary of Treasury rather than an independent individual.<sup>26</sup> All these factors aggregated really restrict the Council’s ability to perform its duties. With these types of limitations on the Council’s power, the Council runs the risk of being a sword without an edge that can become utterly meaningless in a fight.

Also, the Act names the Council as a mediator between the agencies involved in the financial industry, which in theory is a step in the right direction but in actuality may not have effect. The question arises whether the Council actually has the power to mediate the disputes that are bound to arise if the regulatory agencies are not able to coordinate their industry specific objectives with the Act’s objectives.<sup>27</sup> If the Council does not have enough manpower to do fulfill its responsibilities without borrowing resources from other agencies, how is it supposed to enforce mandates against those same agencies it relies on? The extent of limitations on the Council’s power are even more disturbing considering the lack of clear guidance as to what constitutes systemic risk, as discussed below. Because the Dodd-Frank Act does not actually define “systemic risk,” the Council is required to determine which risks are systemic with its minimal powers and potential susceptibility of being influenced.<sup>28</sup> While there are always advantages to flexibility and taking into account changes within the financial market, the concern is present that the Council may just not have the resources or the actual power to define systemic risk and take affirmative action to prevent it.<sup>29</sup>

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25. *Id.* at 6.

26. *Id.*

27. *Id.*

28. *Id.* at 11

29. *See id.* at 11.

One criticism that deals with Title IV specifically is that through the regulations that set forth standards for when an investment adviser must register under the Advisers Act, Title IV does not recognize that private equity funds probably do not also create systemic risk due to their structuring and mode of operations; yet, it imposes increased federal regulation on them.<sup>30</sup> While requiring registration for a non-contributory entity, Title IV ignores smaller hedge funds. Title IV does not impose too much regulatory oversight over smaller hedge funds via the means of registration under the Advisers Act. However, studies demonstrate the inaccuracy of that viewpoint in that they are much likelier to commit investment adviser fraud.<sup>31</sup> The smaller funds are likelier to commit fraud than the bigger ones because the larger and more established funds are already under heightened scrutiny from their institutional investors that small hedge funds may not necessarily attract.<sup>32</sup> With more institutional investors comes increased due diligence regarding the funds, which functions as an additional barrier against fraudulent activity.<sup>33</sup> In general, the regulations seem more focused towards individual firms where each firm is considered separately without taking into consideration the effect of coordinated conduct amongst the market participants.<sup>34</sup>

By focusing primarily on systemic risk at the expense of investor protection, the Act ignores the very possible reality of losing investors due to the vast informational asymmetry between the funds and the investors.<sup>35</sup> Informational asymmetries make it much more difficult for investors to know the true value of their investments, which could cause the hedge fund industry to lose investors.<sup>36</sup> Because the markets are all inter-connected, the hedge fund industry's loss of investors could adversely impact the overall stability of the economy, thereby increasing the systemic risk.<sup>37</sup> Once again, this demonstrates that by focusing almost exclusively on minimizing systemic risk at the expense of other principles, the Act is instead perpetuating the various possibilities through which systemic risk could increase.

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30. Chertok, *supra* note 14, at 6.

31. Martin, *supra* note 13, at 109. The Alternative Investment Management Association actually found that most hedge fund fraud cases involved advisers with \$25,000,000 under their management. *Id.*

32. *Id.*

33. *See id.*

34. Whitehead, *supra* note 21, at 6.

35. Martin, *supra* note 13, at 123.

36. *Id.* at 123-125.

37. *Id.*



Furthermore, Act has invested heavily in preventive regulation and supervision to prevent a future crisis through the creation of new institutions to monitor for future shocks and to direct financial firms to reduce their exposure to systemic crises.<sup>38</sup> However, economic shocks are rarely predictable and they usually happen so suddenly that bureaucracies cannot respond effectively.<sup>39</sup> With the type of federal regulation that the Act imposes and the agencies more interdependent on each other with the goal towards cooperation, the bureaucracy just seems to be getting bigger. Rationally, it would be even harder presently than it was before to convince the agencies to agree on a mode of response. Again, this difficulty ties back to the inherent weakness in the organizational structure with the Council's lack of power for enforcement and implementation, and thus the response time would be substantially longer.

Not only is the size of the bureaucracy an issue, it is not realistic to expect that all future failures will be carefully managed under governmental supervision due the "domino effect."<sup>40</sup> When one institution fails, that is not necessarily caused by systemic risk that could collapse an entire economy; instead, the failure of one institution could set off a domino effect of other institutions' failures due to interconnections between the institutions and the chance that the risks faced by each institution are closely correlated as a whole.<sup>41</sup>

While greater regulatory oversight is a step towards the right direction, sole reliance on that is not enough due to factors such as the inherent fragility of financial institutions, interconnections among the institutions, the close relation of the risks they face, and the political economy of financial regulation.<sup>42</sup> Based on these innate weaknesses within the industry, despite the increased federal regulation, there will still not be enough advance prediction of a financial collapse. Even if the prediction is accurate, the response will not be adequate.<sup>43</sup> Along with the weaknesses within the market as a whole, studies show that there is a recurring cyclical pattern. After a market crash, there is always a period of rigorous regulation with increased scrutiny, that is then always followed by gradual relaxation of the rules.<sup>44</sup> This recur-

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38. John C. Coffee, Jr., *Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight*, 111 Colum. L. Rev. 795, 797 (2011).

39. *Id.*

40. *Id.* at 799.

41. *Id.* at 801.

42. *Id.* at 802.

43. *Id.*

44. John C. Coffee, Jr., *Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight*, 111 Colum. L. Rev. 795, 815 (2011).

ring cycle usually occurs because human nature dictates that bounded rationality is an appropriate mode of behavior, which leads to being predictably blindsided by a new crisis.<sup>45</sup> Due to bounded rationality, there are cognitive limitations on the ability of private entities and public regulators to perceive new risks, which is why the emphasis on preventive measures will never function as they ought to as a protector of the financial industry.<sup>46</sup> Based on this cycle, the supervisory and preventive measures that are supposed to minimize systemic risk will eventually be relaxed. With the government's almost sole reliance on these measures, the economy will be left vulnerable.

A highly prevalent criticism of the Dodd-Frank Act is that despite the emphasis the Act places on systemic risk, there is still no clear definition of what exactly constitutes systemic risk, which creates uncertainties as to when systemic regulation should apply and the type of events that can trigger a regulatory intervention.<sup>47</sup> One of the more common descriptions is that once an economic shock occurs that affects at least one financial institution or market, the shock then affects the flow of capital, which limits the ability of borrowers to make new investments and then impacts the broader economy as a whole.<sup>48</sup> However, that is one of many definitions and even if it is accepted, it is not clear enough to provide any real guidance. By not providing a clear definition of systemic risk, the Act also ignores the problem of negative externalities, which includes the effect of losses resulting from risks borne by financial firms that can extend to others within the economy at a large.<sup>49</sup> The Act's purpose is to provide regulatory organizations such as the Council the ability to step in and try to restrict the amounts and types of risk-bearing a financial firm can assume, but without an actual definition of what could lead to "systemic risk" for an individual firm, the regulatory organizations may not be able to do so.<sup>50</sup> Majority of the Act's "systemic risk" requires implementation of regulation that allow the regulators discretion to modify the statutory standards or issue exemptions; but, without a clear definition of systemic risk, those charged with implementing the new rules may have a hard time coordinating regulation, minimizing their expended efforts.<sup>51</sup>

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45. *Id.*

46. *Id.*

47. Whitehead, *supra* note 21, at 7.

48. *Id.* at 8.

49. *Id.*

50. *See id.* at 9.

51. *Id.* at 10.

Because the focus of defining “systemic risk” within the Act has been on entities that are “too big” or “too interconnected to fail,” it is unclear that without a clear definition, whether an organization like the Council would even be able to determine which entities are systemically important or when their failure would create a systemic problem.<sup>52</sup> There is just too much ambiguity in what constitutes and leads to systemic risk, and as history as shown, reaffirmed by the recent financial crisis, the markets do not react well to ambiguity.<sup>53</sup> By not providing clear guidance of what is systemic risk, the Act might not be able minimize systemic risk exactly when it is needed the most.

Finally, by focusing so much on systemic risk, while still leaving many gaps, the Act ignores several of the investor protection issues created by the hedge fund industry.<sup>54</sup> Traditionally, investor protection was considered to be a non-issue with hedge funds due to the sophistication of the investors and the presumption that they could fend for themselves. However, commentators have posited that regardless of their level of sophistication, the informational challenges that the investors face prevents them from adequately protecting themselves, which in turn worsens the systemic risk inadequacies.<sup>55</sup> Despite the relative sophistication of hedge fund investors, the overall impact on investor protection is minimal, which then again impacts systemic risk. By not imposing affirmative requirements on hedge funds in favor of investor protection, the Act does not provide incentives against bad behavior such as fraud, which leads to systemic risk. As discussed above, because of the structure of many of these financial institutions, a defect in one can have widespread consequences and impact the rest of the economy. Rather than focusing on investor protection, the Act focuses more on systemic risk, thereby missing the possible connections between the two.

### *Alternatives to the Dodd-Frank Act*

Due to the onslaught of criticism that began almost immediately after the enactment of the Dodd-Frank Act, numerous alternatives

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52. *Id.*

53. *Id.*

54. Martin, *supra* note 13, at 89.

55. *Id.* at 90. Some of these informational challenges include: (1) lack of standardization within the industry especially regarding disclosure practices, risk assessments and valuation procedures; (2) lack of standardization along with a limited public disclosure regime makes it very hard for investors to adequately investigate a particular hedge fund investment; and (3) difficulty for investors to choose an optimal hedge fund investment because the informational challenges make it harder for them to compare a wide range of hedge fund opportunities that then limits investor choice and competition within the industry. *Id.*

have been proposed that could fill in the gaps that are still left wide open by the Act. This Article proposes that the institution of an international financial regulator is best suited to solve many of the problems left unresolved by the Dodd-Frank Act, while also disincentivizing firms from becoming “too big to fail”.

Implementation of an international financial regulator takes care of many of the prevalent criticisms of the Act for several reasons. First, the Act is almost COMPLETELY silent about the international dimension of finance; due to the globalized nature of our society, international coordination is going to be required to deal with another crisis when it comes.<sup>56</sup> While the Act deals with Ponzi schemes similar to Bernie Madoff’s and need to the assess the level of systemic risk imposed by hedge funds, the focus is only within the American financial system.<sup>57</sup> However, that ignores the reality which is that within the present financial structure, many hedge funds are global with international investors. Focusing only on American risks leaves open literally an entire world of potential sources of systemic risk that are unaccounted for.

In order to truly combat systemic risk and reduce the chances of another financial collapse, there must be a single global regulator of hedge funds custodians to detect fraud and assess the level of systemic risk imposed by hedge funds in the global financial system.<sup>58</sup> Implementation of an internal regulator does not need reversal of the Act or even counteract its effects. Instead, this global regulatory body would work in conjunction with provisions that are already present within the Act. For example, Section 411 of the Act authorizes the SEC to adopt rules requiring investment advisers to hedge funds to safeguard client assets over which they have custody.<sup>59</sup> This provision would remove the ability of an investment adviser to pay the proceeds invested by new investors to old investors, which is exactly what Bernie Madoff managed to accomplish through his Ponzi scheme.<sup>60</sup>

However, this is not enough by itself; the global regulator would oversee these custodians. The custodians would then be required to submit sufficient information for effective oversight to protect investors and assess the level of systemic risk posed by hedge funds within

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56. Seligman, *supra* note 1, at 12.

57. Cheryl Nichols, *Addressing Inept SEC Enforcement Efforts: Lessons from Madoff, the Hedge Fund Industry, and Title IV of the Dodd-Frank Act for U.S. and Global Financial Systems*, 31 NW J. INT’L L. & BUS. 637, 641 (2011).

58. *Id.*

59. *Id.*

60. *Id.* at 690.

the global financial system.<sup>61</sup> While the Act has taken massive steps towards remedying a non-transparent segment of the American financial system, its effectiveness in furthering investor protection and protection against systemic risk needs additional steps, which would be accomplished by a single global regulator.<sup>62</sup> The SEC even emphasized this based on Commissioner Casey's statement in front of the Senate Banking Committee, where she stated: "[t]he [SEC's] commitment to international cooperation has become increasingly important to its mission in recent years in response to the increasingly global nature of financial markets."<sup>63</sup>

This is in recognition that many hedge funds and their advisers are global entities that are interdependent within the global financial system, as evidenced by the spread of the 2008 financial crisis that spread to most major financial centers, regardless of what country they were located in.<sup>64</sup> Furthermore, the regulation must be global because different national standards for each individual country's financial institutions make it possible for regulatory arbitrage and gaps in oversight.<sup>65</sup>

Along with acting as a single regulator for entities that already transcend territorial and sovereign boundaries, this global regulator would also function as a verifiable comprehensive non-industry controlled source of information about hedge funds and their nature and scope.<sup>66</sup> As discussed above, Title IV is severely lacking in implementing protective measures for investors, and a financial global regulator could cure numerous of those defects. For example, not all prospective investors have the capacity or the expertise to analyze the information they receive about hedge funds, and even if they have the ability, there is limited transparency because hedge funds are not required to provide extensive disclosures to their investors unlike mutual funds.<sup>67</sup> Without a mandatory disclosure regime, relevant information is not provided to its regulators, which is needed to better detect investment adviser fraud.<sup>68</sup>

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61. *Id.* at 642.

62. *Id.* at 696.

63. Nichols, *supra* note 57 at 696, (quoting International Cooperation to Modernize Financial Regulation: Hearing Before the Subcomm. on Sec. and Int'l Trade and Fin. of Banking, Hous., and Urban Affairs 111th Cong. 7 (2009) (statement of Kathleen L. Casey, Comm'r Sec. & Exch. Com.m'n)).

64. *Id.* at 696.

65. *Id.*

66. *Id.* at 697.

67. Martin, *supra* note 13, at 113-115.

68. *Id.* at 116.

With the implementation of a global financial regulator, the entity could impose a mandatory disclosure regime that Title IV is lacking, which would enhance the transparency between the funds and the investors. This would better facilitate the selection process for hedge funds by giving the investors the tools necessary to compare the various funds and find one that best suits their needs. In order for them to accurately select one that best suits their needs, there must be a standardized method for investors to compare and aggregate risks across various portfolios, which there currently is not.<sup>69</sup> The federal regulator would provide a standardized method of comparison between the various portfolios. Because hedge fund advisers would be required to submit the pertinent information to their national regulator, who would then submit the information to the international regulator, potential investors would have one source through which it could examine all the relevant information that is important to them and select accordingly. The global regulator would also provide an additional layer of protection against fraudulent activities.<sup>70</sup>

Based on the numerous advantages that are present with a federal regulator, coupled with the detrimental effects if the regulation of hedge funds is left to each individual country, a new institution should be implemented that would be truly global. This global regulator must oversee the hedge fund advisers and custodians, with each country's systemic risk regulator reporting directly to this entity.<sup>71</sup> Additionally, to ensure that this global regulator has actual power and is not left in limbo where it might or might not have power, the implementation of global regulatory decisions need to be mandatory in each member country.<sup>72</sup>

Moreover, to ensure that this global regulator is not stepping similar to how national regulators have had to step in the past for firms that

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69. *Id.* at 121. The four components of risk that are generally evaluated are volatility, diversification, leverage and liquidity. *Id.* at 122. Volatility is the amount of uncertainty associated with the value of a particular investment. *Id.* Diversification is the extent to which a portfolio includes a wide variety of investments. *Id.* Leverage is the ratio of a firm's debt to its equity capital, while liquidity is whether an investment can be easily sold or exchanged for cash without a subsequent substantial loss in value. Martin, *supra* note 13, at 122.

70. *See id.* at 120. Not only is there limited transparency, there is also a lack of standardized valuation mechanisms that are consistent across the industry, which is especially concerning because hedge fund managers are compensated based on the overall value of the fund's assets, thereby creating a general concern that managers have an incentive to inflate valuations to increase their compensation. *Id.* Having a federal regulator would also allow the entity to impose standard valuation practices, which would streamline the compensation packages hedge fund managers receive, precluding any inclination to participate in fraudulent activities.

71. Nichols, *supra* note 57, at 698.

72. *Id.*

are “too big to fail,” which were part of the cause of the recent crisis, firms must be disincentivized from getting so large. The “too big to fail” has been at least the American government’s policy of awarding discretionary support to a firm’s underinsured creditors, which rather than helping the industry, has actually impeded the industry.<sup>73</sup> When governmental bodies are consistently intervening to support distressed financial institutions, the expectation of intervention continues, thereby increasing the chances of these firms taking excessive risks based on their confidence of an intervention if they border insolvency.<sup>74</sup> Rather, with the possibility of a bailout, financial firms have the incentive to continue growing to reach the “too big to fail status,” which leads to excessive risk-taking and economic waste.<sup>75</sup> Thus, along with creating an international financial regulator, disincentives must be provided to firms to discourage them from the incessant growth. It is important that even with an international financial regulator, firms are disinclined to take steps for excessive growth.

While not too much is studied about the costs of imposing an international financial regulator, an analogy can be drawn to other areas involving hedge funds. For example, one commentator has emphasized an increased need for investor protection regarding hedge funds, but even she agreed that there may be some costs such as deterrence for hedge funds operating within the United States, political hurdles and cost limitations.<sup>76</sup> Those same costs would also apply to the global regulator. With an overall “supervisory” entity overlooking and scrutinizing the hedge funds’ moves, the funds may be deterred from operating in countries that are members of the global regulatory organization. In order for the global regulations to work, countries would need to agree to become members of the organization, and not every country may do so. Therefore, hedge fund managers may be deterred from operating in countries that have signed onto the regulatory organization, which could then impact the overall strength of the economy.

Second, political hurdles are bound to arise in an *international* organization comprised of nations that have their own interests and agendas to push. Not only are conflicts of interest bound to arise between various members, some countries might also balk at the notion

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73. Elisa S. Kao, Article: *Moral Hazard During the Savings and Loan Crisis and the Financial Crisis of 2008-09: Implications for Reform and the Regulation of Systemic Risk Through Disincentive Structures to Manage Firm Size and Interconnectedness*, 67 N.Y.U. ANN. SURV. AM. L. 817, 823 (2012).

74. *Id.* at 823-824.

75. *Id.* at 824.

76. Martin, *supra* note 13, at 138-40.

of taking orders from a third party that could detrimentally impact their national economy. Under the assumption that at least half the countries would sign to be a part of the international regulatory organization, the global regulator would have a momentous task ahead of it in balancing the various countries' competing interests, while ensuring that its mandates are being followed and the purpose of the organization is fulfilled. Finally, there are cost limitations associated with the international regulator; it would need a vast amount of resources in terms of manpower and capital to function. Not only would it need to have the capabilities to process all the acquired information to provide accurate information about systemic risk within the industry, it would also need to provide comprehensive information for investors to understand and analyze in furtherance of the increased transparency and investor protection objectives. In order to enforce its mandates to ensure that all member countries are abiding by its dictates, the international regulator needs manpower for enforcement, lest it become an organization similar to the Council, one with no bite.

However, despite these costs that are associated with the international regulator and the kinks that need to be worked out, the benefits associated with a truly global financial organization far outweigh the associated costs, especially considering the power it could take to minimize if not prevent another economy crisis similar to the one that recently struck the United States' financial economy and then spread throughout.

#### CONCLUSION

The Dodd-Frank Act was a great step in the right direction towards rectifying several of the mistakes that contributed to the latest economic downturn. However, there are several omissions and gaps throughout the legislation, especially in Title IV's provisions on hedge funds, that ignore numerous of the realities of today's financial market. By focusing almost exclusively on systemic risk at the expense of other areas that are deserving of protection, the Act has instead perpetuated some of the same risk factors that led to the economy crash. A global financial regulator functions to fill in many of the gaps that are left open by the current Act, while simultaneously promoting other areas such as increased focus on transparency and investor protection. Even though there may be increased costs associated with a global financial regulator, the benefits far outweigh the costs. One of the greatest benefits to an international regulator is that it can work in conjunction with the provisions already implemented; a restructuring



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of the rules is not required. Thus, to truly minimize systemic risk, which is what Dodd-Frank is geared to do, an international financial regulator is an effective tool.